

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
TRETORN AND SUMARN PUGKHEM	:	DETERMINATION
for Redetermination of a Deficiency or for	:	
Refund of Personal Income Tax under Article 22	:	
of the Tax Law for the Years 1982, 1983 and	:	
1984.	:	

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Petitioners, Tretorn and Sumarn Pugkhem, 130 Sycamore Drive, East Hills, New York 11576, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1982, 1983 and 1984 (File No. 807049).

A hearing was commenced before Joseph W. Pinto, Jr., Administrative Law Judge, on January 12, 1990 at 10:30 A.M., at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York and continued to conclusion before the same Administrative Law Judge at the same location on March 21, 1990 at 2:45 P.M. Petitioners appeared by Kenneth I. Singer, C.P.A. The Division appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly characterized transfers of funds from Tretorn Pugkhem M.D.P.C. to Tretorn Pugkhem, petitioner, as taxable dividends for the years 1983 and 1984.

II. Whether the disallowance of certain deductions taken by Tretorn Pugkhem M.D.P.C. because they were personal in nature resulted in constructive dividends taxable to petitioners for the years 1983 and 1984.

III. Whether the Division of Taxation properly disallowed Schedule E rental losses from a certain rental property on Marco Island, Florida for the years 1983 and 1984.

IV. Whether the Division properly disallowed a Schedule D capital loss claimed by

petitioners for the year 1983 on the alleged sale of a second rental unit located on Marco Island.

#### FINDINGS OF FACT

On February 27, 1989, the Division of Taxation issued to petitioner Tretorn Pugkhem a Notice of Deficiency for the year 1982 which set forth additional tax due in the sum of \$3,711.00, penalty of \$1,949.00 and interest of \$2,342.41, for a total amount due of \$8,002.41. On the same date, the Division issued to petitioner Sumarn Pugkhem a Notice of Deficiency for the year 1982 indicating additional tax due of \$2,368.00, penalty of \$1,243.00 and interest of \$1,494.91, for a total amount due of \$5,105.91. Petitioners did not contest the tax due set forth on these notices of deficiency and concede their accuracy. However, petitioners do contest the assessment of penalty and additional interest and that amount remains in dispute herein.

On February 27, 1989, the Division issued a Notice of Deficiency to Tretorn and Sumarn Pugkhem for the years 1983 and 1984 which set forth additional tax due of \$41,394.00, penalty of \$2,070.00 and interest of \$17,428.26 for a total amount due of \$60,892.26.

For the year 1982, there was no record of a return being filed by petitioners and the amount found due and assessed was taken from a copy of said return provided by petitioners herein.

Prior to the issuance of the notices of deficiency, the Division issued a Statement of Personal Income Tax Audit Changes for all three years in issue. The explanation of the additional tax due was as follows:

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>Total</u>
Dividend Income - Tretorn Pugkhem, M.D.P.C. - Adjustment to reflect amounts deemed to be dividends, not loans		\$ 18,064.00	\$43,242.00	
Constructive dividends - Tretorn Pugkhem, M.D.P.C. - Corporate deductions disallowed as being personal in nature		76,667.00	48,095.00	
Schedule E - Rental loss disallowed		37,033.00	35,534.00	
Schedule A - Itemized deductions disallowed		50,596.00	55,331.00	

Standard deduction		(2,500.00)	(2,500.00)	
Schedule D - Long-term Capital loss Disallowed		3,000.00		
Net adjustment		182,860.00	179,702.00	
Taxable income previously stated		72,951.00	95,614.00	
Corrected Taxable Income		255,811.00	275,316.00	
Tax on corrected taxable income		28,339.00	29,798.00	
NYC Tax - NYC 203		457.00	482.00	
Corrected Tax Due		28,796.00	30,280.00	
Tax Previously Computed as corrected		7,112.00	10,570.00	
Total Additional Tax Due	6,079.00	21,684.00	19,710.00	47,473.00
Penalty Pursuant to 685(a)(1)	1,368.00			1,368.00
Penalty 685(a)(2)	1,520.00			1,520.00
Penalty 685(b)	304.00	1,084.00	986.00	2,374.00

Interest	3,740.00	10,275.00	6,576.00	20,591.00
Totals	\$13,011.00	\$ 33,043.00	\$ 27,272.00	\$73,326.00

Subsequent to the first hearing in this matter, a representative of the Division met with petitioners' representative. Further substantiation was offered in support of the various items set forth in the explanation of the Statement of Personal Income Tax Audit Changes above. In light of this substantiation provided by petitioners' representative, further reductions in the assessment were made as follows:

<u>Item</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Dividend Income - Adjustment to reflect amounts deemed to be dividends, not loans (Tretorn Pugkham, M.D.P.C.)		\$18,064.00	\$43,242.00
Item 2 Constructive Dividend - Tretorn Pugkhem M.D.P.C. - to reflect corporate deductions disallowed as being personal in nature		19,270.00*	23,780.00*
Item 3 Schedule E - Rental loss disallowed	37,033.00	35,534.00	
Schedule A - Itemized deduction Interest Expense - IRS not substantiated			1,107.00
Schedule A - Miscellaneous deductions - disallowance of 50% to reflect additional travel and entertainment and auto expense not allowable		4,317.00	3,532.00
Schedule D - Capital loss disallowed as unsubstantiated		<u>3,000.00</u>	
Revised Audit Adjustments		<del>81,684.00</del>	<del>107,195.00</del>
*Corporate deductions disallowed as personal: Client development (at 50%)		14,614.00	9,939.00
Professional meetings (at 50%)		1,577.00	758.00
Auto Expenses (at 49%)		<u>3,079.00</u>	<u>13,083.00</u>
Total - Deemed constructive dividend		19,270.00	23,780.00

For 1982, there was no record of a tax return being filed. The balance due as per petitioners' copy of the return was therefore asserted at \$6,079.00 plus appropriate penalty and interest.

Tretorn Pugkhem drew a salary from the professional corporation by means of promissory notes, specifically in the years 1983 and 1984. At the end of the corporation's fiscal year, June 30, a determination was made by Tretorn Pugkhem and his accountant as to how much salary should be recognized for the fiscal year. When this figure was calculated, an equal amount in promissory notes was marked "paid" or forgiven by the corporation and an entry made of that amount in the general ledger under salary. Any outstanding notes were made payable in the next fiscal year.

In support of their system, petitioners submitted promissory notes for the fiscal years ended June 30, 1983 and 1984 which were marked "paid", thus signifying forgiveness of the indebtedness by the corporation. Said notes were issued on preprinted forms issued by the Julius Blumberg Co. entitled "non-negotiable note." The dollar amount was stated in the upper left hand corner. The date of the note was set forth in the upper right hand corner, and each of the notes set forth that the sum of money was payable to "bearer" on demand with no specified location at a set interest of 10% per annum. At the bottom right hand corner each of the notes was signed by Tretorn Pugkhem.

Petitioners disputed the disallowed corporate deductions which were characterized as personal expenses and treated as constructive dividends of Tretorn Pugkhem M.D.P.C. even after reductions were made by the Division prior to the second hearing date. Petitioners did not dispute the Division's finding that the disallowed corporate deductions were not ordinary and necessary business expenses. These expenses were in the areas of client development, professional meetings and automobile expenses.

With regard to Tretorn Pugkhem's interest in unit number 1611, South Seas Northwest IV, Marco Island, Florida, petitioners submitted a letter dated March 6, 1990 from Marco Beach Rentals, Inc., a management company, which stated that it represented Dr. Pugkhem with regard to said unit and alluded to an attached management agreement between the company and Dr. Pugkhem. However, said management agreement was not submitted into evidence and it is not known whether the agreement covered the years in issue.

With regard to unit number 1705, South Seas Northwest IV, Marco Island, Florida, for which petitioners sought to take a capital loss for the year 1983, petitioners submitted only a warranty deed indicating that a property interest in the unit was transferred to Dr. Pugkhem and two other parties on August 11, 1981 by Marco Island Beach Front, Inc. No evidence with regard to its sale was submitted.

Petitioner Tretorn Pugkhem executed an employment agreement with Tretorn Pugkhem M.D.P.C. on September 10, 1975, which provided in section 4(h) that any benefits provided the employee by employer which were disallowed by any taxing authority would be considered a loan payable with interest to the employee from the employer and would be repaid as soon as Notice of Disallowance was given by the appropriate taxing authorities to the employer.

#### CONCLUSIONS OF LAW

A. With regard to the issue of salary, Dr. Pugkhem's practice of waiting until the end of each fiscal year to determine how much salary he would draw is determined to be invalid and the additional money withdrawn from the corporation during the years in issue is determined to be dividends.

The fact that petitioner Tretorn Pugkhem and his accountant met at the end of each fiscal year and decided what amount of salary would be declared for the prior fiscal year was a sham transaction. There was never any intention to repay the notes nor was there any reasonable expectation by the corporation to receive payment on said notes at any time. Each of the notes was forgiven as soon as it was deemed to be salary for any specific fiscal year. This did not constitute a legitimate loan.

Although the Internal Revenue Code does not define what constitutes a loan, it has been held on numerous occasions that an intent to repay must be present at the time the loan is made. (Matter of Robert Fancher, State Tax Commission, April 6, 1979, citing Genito v. United States, 80-2 US Tax Cas ¶ 9771 [1980].) Further, the question of whether advances from a corporation to its shareholder constitute a dividend rather than a loan is one of fact. (Wiese v. Commissioner, 93 F2d 921 [1938], cert denied 304 US 562.)

In Purty v. Commissioner (26 TCM 409 [1967]), various criteria were set forth to determine whether withdrawals of corporate funds by a sole stockholder, as in the case of Tretorn Pugkhem herein, constituted dividends or loans, to wit: (a) whether the withdrawals as loans or receivables were treated consistently on the corporate books; (b) whether the execution of the notes was proper; (c) whether there was sufficient earned surplus available to cover the withdrawals; (d) whether there was evidence of repayments of the loans; (e) whether the borrower had the financial ability to repay the withdrawals; and (e) whether the borrower made personal guarantees or collateralization of the loans.

As in the instant case, where a sole shareholder entirely controls the corporation, close scrutiny of the situation is warranted (Eliot J. Roschuni, 29 TC 1193 [1958], affd per curiam 271 F2d 267 [5th Cir 1959], cert denied 362 US 988).

Since the only evidence presented by petitioners herein consisted of promissory notes marked "paid", and the unsworn arguments of its representative at hearing, it is determined that petitioner has not established the validity of the loans and therefore the Division properly disallowed the alleged loans and determined same to be dividends paid by the corporation to Tretorn Pugkhem (Wiese v. Commissioner, supra).

B. The next issue is whether certain disallowed business expenses of Tretorn Pugkhem M.D.P.C. should be characterized as constructive dividends of Tretorn Pugkhem subject to personal income tax.

Petitioners did not dispute the disallowance of the corporate expenses as not ordinary and necessary business expenses pursuant to Internal Revenue Codes § 162. It is well established under Federal case law that if an employer pays an employee's personal debts or expenses, the payment must generally be included in the gross income of the employee (Old Colony Trust Co. v. Commissioner, 279 US 716, 729 [1929]; Conole v. Commissioner, 30 TCM 467, 477 [1971]). Since petitioners were not able to substantiate that certain expenses were ordinary and necessary business expenses of Tretorn Pugkhem M.D.P.C., they were determined to be personal in nature and characterized as constructive dividends to Tretorn Pugkhem. This

included deductions in the categories of client development, professional meetings and automobile expenses. (See, Matter of Harold Small and Irene Small, Tax Appeals Tribunal, August 11, 1988.)

Given petitioners' failure to provide any evidence with regard to this issue, it is determined that the Division properly assessed additional income to petitioners pursuant to its theory of constructive dividend.

C. With regard to the issue of whether or not the Division properly disallowed Schedule E rental losses for 1983 and 1984 on the property known as unit 1611, South Seas Northwest IV, Marco Island, Florida, it must be noted that the only evidence of petitioners' owning a rental property was a letter from a management company dated March 6, 1990, some six years after the period in issue, which omitted the copy of a management agreement originally attached to it which would have been dispositive of the issue. Since petitioners have not even established ownership of said property, let alone its rental status for the period in issue, the Division was correct in disallowing the Schedule E rental losses.

D. Finally, with regard to the capital loss claimed by petitioners on the sale of property known as unit 1705, South Seas Northwest IV, Marco Island, Florida in 1983, petitioners failed to submit any evidence of the sale of said property. Although they produced a deed which showed that Tretorn Pugkhem was in fact one of three owners of said property, petitioners failed to substantiate that a sale of said premises ever took place. Therefore, no capital loss is justified.

E. It is determined that the Division properly assessed penalties pursuant to Tax Law § 685(a)(1), (a)(2) and (b) for the year 1982, since no return was filed and no payment made. Further, it is determined that the Division properly assessed the penalty pursuant to Tax Law § 685(b) with regard to the years 1983 and 1984. Once again, petitioners have the burden of proof and failed to come forth with any evidence indicating that such penalty should not be imposed. (See generally, Tax Law § 689[e].)

F. The petition of Tretorn and Sumarn Pugkhem is denied, and the notices of deficiency

dated February 27, 1989, as adjusted by the Division (see Finding of Fact "5"), are sustained together with such additional interest as may be lawfully owing.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE